DOW THEORY LETTERS INC.

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Oct. 1, DJIA 979.89; PTI 709; A-D Ratio -22.29
Oct. 8, DJIA 952.38; PTI 701; A-D Ratio -23.98

THE PICTURE: The worries are building. Jimmy Carter seems to be implying that President Ford is a Red agent on the take. Britain has raised its bank rate to an astronomical 15%. Business forecasts in the US are being revised downward. And the 1000 level on the Dow stands above us like a great, impregnable fortress.

Meanwhile, the Averages have retreated to levels not seen the first quarter of 1976. And in general, the stock market hasn't done anything profitable since last February. If the US public had any further doubts about the idea of leaving Wall Street, those doubts are rapidly being erased. Over the last eighteen months the American public has pulled out almost $3 billion from mutual (stock) funds. The public has been selling its odd lots for so long that the majority of Wall Street brokers don't know what a day of odd-lot buying looks like.

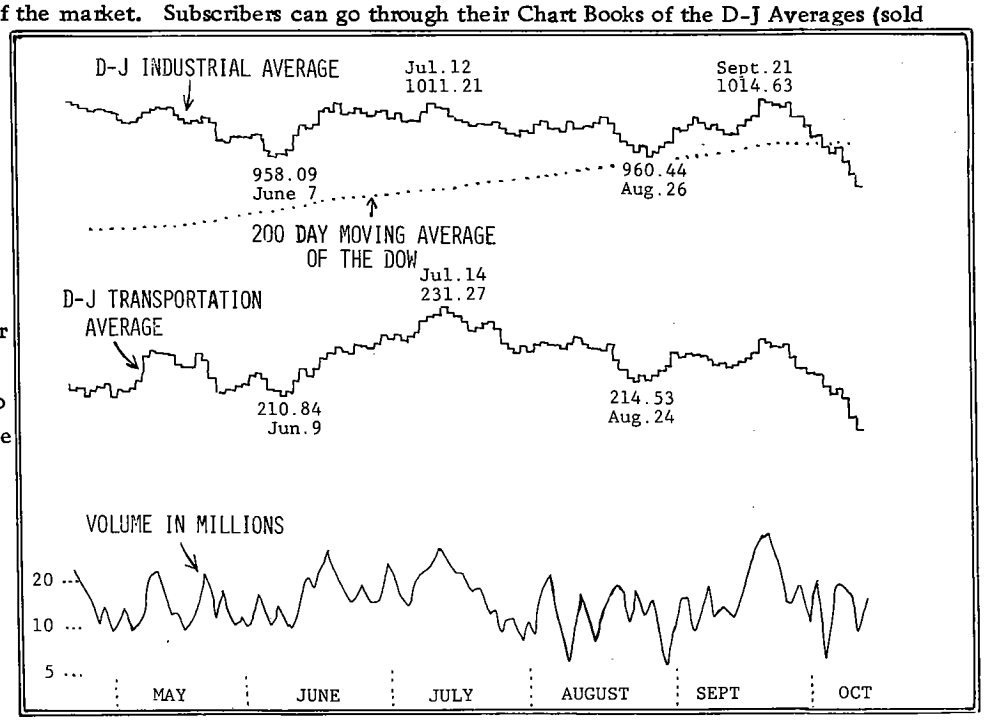
The big brokerage houses, in their wisdom, have turned to endeavors other than stock-selling, and they are now selling bond unit trusts, insurance, tax shelters, options, real estate plans, and various other non-stock items. At the same time many stock market advisories are feeling the pinch of the exiting public, and a number of publications are now folding or are in the process of drifting away (don't worry, this service has never been further from such action).

In the meantime, the British market has been providing its own version of the "Rocky Horror Show." The British Industrials have dropped from a 1976 high of over 420 to last week's figure of under 300, a loss of about 30%. This just about qualifies it as a crash, and in view of that action (see Letter 675, page 4) the US market cannot be blamed for "protecting itself."

In case you're wondering, I am not presenting all this to depress my readers. In fact, just the opposite is true. In this mailing I have taken up a large amount of space to present what I consider to be a most optimistic long-term perspective. That perspective is based on an interpretation of the market under the Elliott Wave Principle. I find Elliott particularly interesting and (hopefully) significant at this time. It is based on form (pattern), not timing, so that patience is always needed where Elliott is concerned. But if Elliott does work out, it is clear that today's pessimists are going to be in for perhaps a decade of surprises in the form of activity on the upside.

I started off the last Letter with a discussion of bull market "selling climaxes." It is increasingly probable that we are on the edge of just such a phenomenon. Whereas primary bear market declines tend to be eroding and tedious, taking everything (utilities, bonds, industrials, etc.) with them, reactions in a bull market are usually violent, dramatic, selective and newsworthy. They are headline producers because they often bring in heavy volume and because they often actually appear scarier than the true primary decline in a bear market. So it does look to me as though we are heading into a typical bull market selling climax. With that climax should also come the most sold-out situation since late-1974.

WATCH BONDS and UTILITIES: One phenomenon particularly fascinates me at this time. A trend in both Utilities and Bonds almost always sets the stage for the rest of the market. Subscribers can go through their Chart Books of the D-J Averages (sold through this advisory), and there are almost no instances wherein (1) a rising trend in both Utilities and Bonds did not set off a rising trend in stocks, and (2) a declining trend in Utilities and Bonds did not trigger a declining trend in the rest of the market. It seems that whatever force is powerful enough to move the Utilities and Bonds up or down together is also powerful enough to effect all other segments of the market.



The interesting situation I am alluding to is that at present the D-J 20 Bond Average and the D-J Utility Average are not only in established bullish trends, they are very close to their bull market highs. I have included a weekly (Friday closings-page 2) chart of the Dow Industrials, the D-J Utility and the D-J 20-Bond Average from mid-1970 to the present. I have

identified all areas in which both the Utilities and Bonds are rising together with the black horizontal bars at the bottom of the page. Note that in each instance where the two money-oriented Averages are rising (whether in the bear market period ending in 1974 or the bull market period starting in December, 1974), the Industrials also enter into a bull trend.

A joint rising trend in Bonds and Utilities began in October, 1975, and that trend is still in force. Despite this, the market has headed down. This is most extraordinary, and the reasons are not as important as the actual fact that it is happening.

Nevertheless, my feeling is that either the Bonds and Utilities are about to top out and the market has jumped the gun on such a possibility—or the market has been "psyched" into a fear-inspired decline which will end as suddenly and dramatically as it began. The situation, based on the extraordinary divergence between the Industrials on the one hand and the Utilities and Bonds on the other, is moving toward the extremes. So far, I do not see any signs that the Utilities and Bonds are topping out. Obviously, they could top, but they haven't yet. In the absence of a top-out in Utilities and Bonds I would have to say that the market is heading towards a dramatic downside conclusion of the 1962 or 1957 variety. The hopeful side of the picture, then, is the thesis that the current market plunge is the flash of lightening that will finally clear the murky air and turn this market definitely upward.

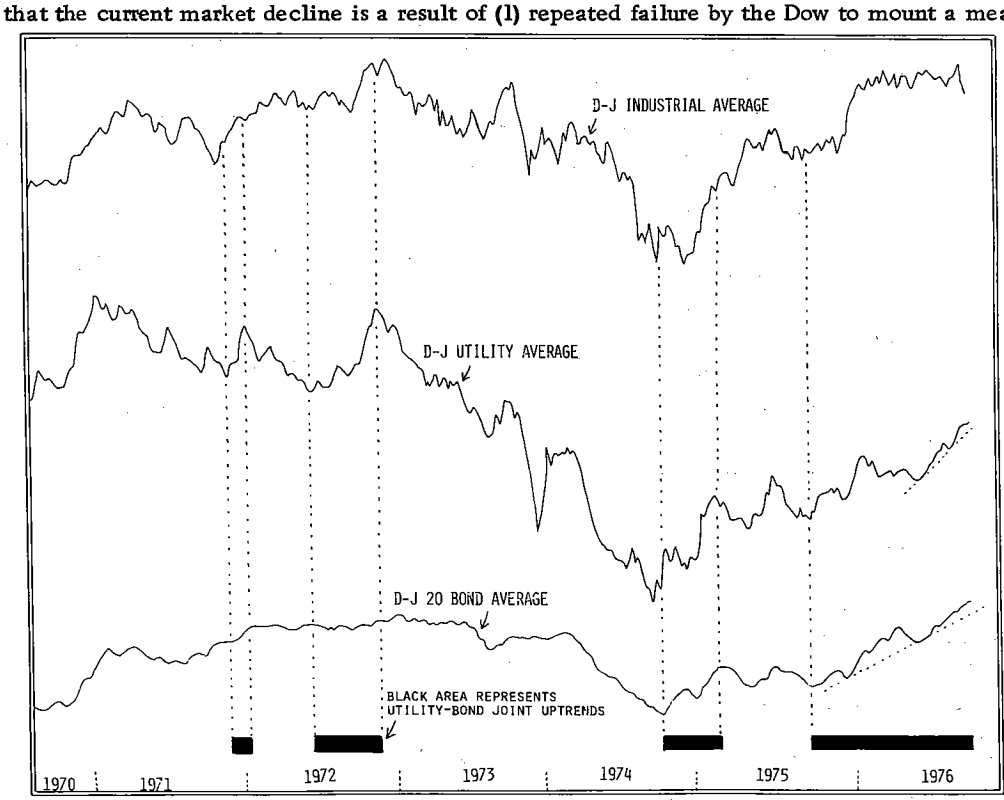
THE AVERAGES: The D-J Industrials recorded their first "above-1000 peak" on March 1 at 1003.31. Since then, there have been many Dow moves above 1000, and four major stabs to the downside. The first decline took the Dow back to 968.28 on April 12. The second fall took the Dow down to 958.08 on June 6. The third downward stab took the Dow to 960.44 on August 26. The Dow then ran up to a new high of 1014.63 on September 21, and turned down again. Last week the Dow broke below all decline lows since February of this year.

The Transports, having climbed above 210 on March 11, sank to a decline low of 200.88 on April 9. A new advance carried them to a bull market high of 231.27 on July 14. From that point on, the Transports turned persistently weak. As this is written, Transports are under the 210 level and eyeing the April low of 200.88. My own feeling is that the 200.88 (April 9) level on the Transports (see page 1 chart) is worth watching carefully at this time. If the Transports choose to hold that level, we could be coming to the end of this dramatic slide. On the other hand, if the 200.88 level is broken, I would take this as a sign of unusual weakness, and I would take an even more cautious stance towards the market (which means selling more stocks and upping the bond portion of your portfolio even further.

COMMENTS: The adverse bond-stock yield disparity has been narrowing steadily, and older subscribers may remember that a device which was termed "Will-Go" served to follow the trend of the yield relationship. Will-Go has been rising for 13 weeks in a row, and in a bull market this should build a forthcoming strong upside "potential."

Institutions of all types may account for as much as 70% of all NYSE volume at this time. I have been talking about an "old fashioned selling climax" on high volume, but it occurs to me that much of the heavy volume on selling climaxes such as the 1957 or 1962 affairs might have been brought on by the public. For this reason, it is possible that all the elements of a selling climax except high volume may be present when this market hits its selling climax lows.

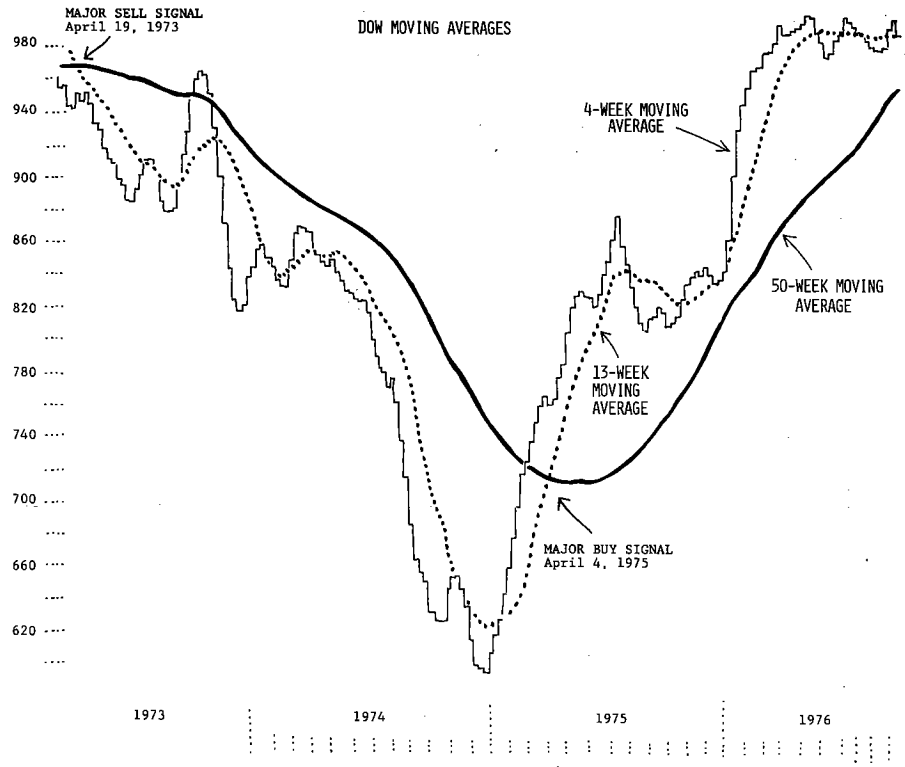
The stock market is rarely, very rarely "surprised" by news. The market is fascinated with tomorrow, only vaguely interested in today, and totally disinterested in yesterday. Consequently, we may take it for granted that today's "news" is little or no factor on stock prices. Personally, I feel that the current market decline is a result of (1) repeated failure by the Dow to mount a meaningful advance above and beyond 1000, with resultant discouragement on the part of investors and traders, (2) the increasing probability of a Carter victory at the polls with all the fear and uncertainty that such a change entails, (3) the rising recognition on the part of money managers that bonds offer "yield and return now" with little risk, versus common stocks which offer less return and a good deal of risk in an economy where growth and inflation are far from assured.



The question everyone is now asking is "what are the support levels on the Dow?" "Where will the downmove stop?" In my last Letter I wrote that a characteristic of second-phase reactions is that they tend to cut right through the widely-watched support levels. This is happening

now. This market will halt its descent when it's exhausted, and the final selling climax low (once it is recorded) will probably not be violated again.

MOVING AVERAGES AGAIN: In Letter 676 I noted that there is a "fail-safe" device which I use. It's very simple and very mechanical. The device is based on three moving averages of the Dow, a short-term or 4 week MA, an intermediate-term or 13 week MA, and a long-term or 50 week MA. Our mechanical "signals" are given as and when the three Averages cross each other's paths.



When the 4 week MA crosses above or below the 13 week MA we receive what I term buying or selling "alerts." These are just what they imply, signals to alert us to a change of trend. By construction, an alert must come prior to a major buy or sell signal. The major signals appear when the 13 week MA moves above or below the 50 week MA.

I should add that I give particular credence to a signal when it comes in harmony with (in the same direction as) the prevailing primary trend of the market. Nevertheless, major signals on the moving averages are given but rarely, and when they do appear they are well worth respecting and acting on.

The accompanying chart is almost self-explanatory. We received a major sell signal on April 19, 1973. If there were any doubts at that time about a bear market's being in progress, that sell signal should have removed those doubts. All readers of these reports were out of the market at the time. In being out, we avoided the worst bear market crash in 36 years.

Bull market buying indications crept into the market during the last quarter of 1974. I might add that we actually did most of our buying during December, 1974 and January, 1975, a few months before the major buy signal on the MA's. We did our buying on the basis of what appeared to be an historic bear market bottom. When the major buy signal of April 4, 1975 arrived, we used it as confirmation of our correct, bullish position.

At no time since April 4, 1975 has the MA study provided us with a major sell signal. However, we have received a series of three selling alerts. The first came on May 27, the second arrived on August 13, and the third came this week (see chart). I have never seen this type of "triple series" of selling alerts before, and I am therefore treating the series with respect. Furthermore, the 13 week MA hits its bull market high at 992 on July 15, and since then it has been declining. (The current value of the 13 week MA is 985).

The crucial point in this study is the fact that the 13 week MA now stands at 985, 31 points above the 50 week MA. Since July 15 the 13-week MA has been falling as the 50-week MA was rising. Over the past ten weeks the two lines have been closing at a rate of about 4 points per week. If this continues, it will be late November or early December before the two lines cross (unless the closure speed accelerates).

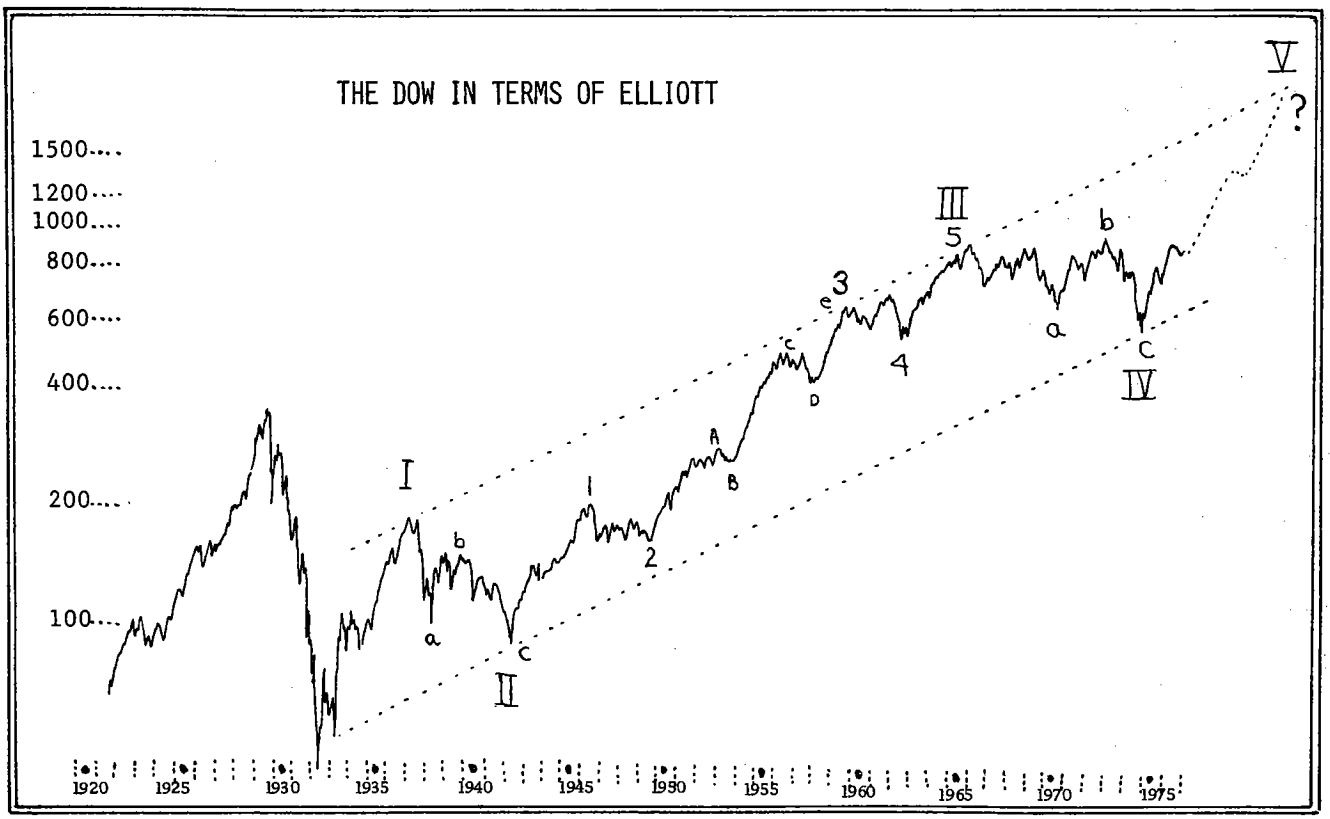
I have recommended caution over recent months, based primarily on the reluctance of the advance-decline ratio to better its February, 1974 high. On September 21, when the A-D finally did confirm, I took this as a hopeful indication, but cautioned that Transports were now the laggards in the technical picture. At the end of Letter 676 (following the "breakout") I asked subscribers not to "chase the market." "The market is always there," I wrote, "and each year during a bull tends to provide one or more outstanding buy spots..."

Unquestionably, we'll see many rallies and declines during coming months. In that period the 13-week MA and the 50-week MA are bound to move closer to each other and perhaps even touch (I don't know, nor does any man alive). But if the market is weak enough to take the 13-week MA under the 50-week MA, this will constitute a major sell signal. That's our fail-safe point. Such a signal could conceivably be a whip-saw, but it could also represent the signal for serious action right into 1977. At that point (a crossing), I would suggest that subscribers turn very cautious and scale back to minimum holdings of common stocks.

Question: Russell, you keep saying that this is a primary bull market. If so, then why would we sell on a downside crossing of the 13-week MA below the 50-week MA, your so-called major sell signal? Shouldn't we just sit it out?

Answer: I have learned, after two decades in the advisory business, that (1) the market can do anything, and (2) there must be a point at which an investor pays the cost of "insurance" against potential disaster. That insurance may cost you a number of losses, but it will keep you solvent in the long run. An investor can take all kinds of limited losses, but he must avoid getting caught in a major collapse of the 1973-74 variety.

The major signals on the MA's have a remarkable habit of coming rather early in extended advances and in extended declines. In other words, they get you out fairly early during massive declines, and they get you in rather early during huge advances. For this reason, I like to be on the "right side" of the MA's. If the MA's cross bearishly, and that crossing turns out subsequently to be a whipsaw, that will be unfortunate. But if they cross bearishly, and we ignore the sell signal and the market then crashes (remember, it can do anything), that isn't unfortunate, that's catastrophic as far as my subscribers and I am concerned.



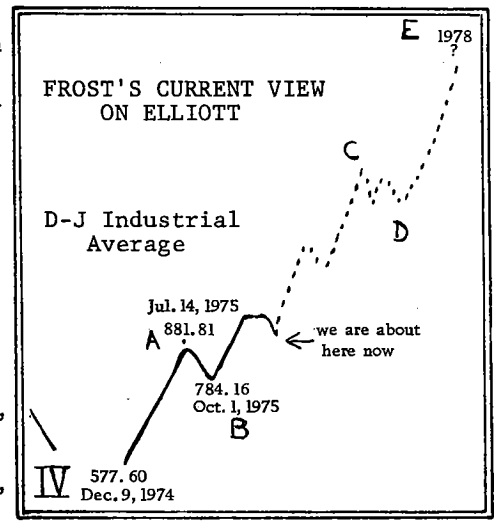
ELLIOTT: In past years, I provided reviews of the market (and occasional stock groups) on the basis of my Elliott Wave interpretations. I used Elliott frequently during 1973-74, and those discussions not only aroused a good deal of interest but they proved most helpful in identifying the end of the great 1966-74 primary bear market.

In Letter 613 (Oct. 30, 1974) I presented a chart showing the action of the Dow Industrials from the late-1920's to October, 1974. This presentation was based on both my own analyses and those of Mr. A. J. Frost of Canada. I personally consider Frost to be the outstanding living exponent of the Wave Theory. Frost did a good deal of work with the late, great Hamilton Bolton, founder of the Bank Credit Analyst. Bolton gave a good deal of credence to Elliott and always attempted to dovetail Elliott's Wave Principle with his own work on bank credit. I used to correspond with Hamilton Bolton regarding the market and Elliott. Mr. Frost was writing occasional Elliott pieces for the Bank Credit Analyst at the time, and I found both his and Bolton's work exciting and thought-provoking. After Ham Bolton's death, Frost's wave studies no longer appeared in the Bank Credit Analyst. Consequently, I began corresponding with Frost myself.

My interest in the Wave Principle has continued through the years. As subscribers may remember, I used Elliott interpretations in my Special Report of December 20, 1974, as part of my thesis that the great primary bear market was over. Perhaps due to the success of Frost's and my own interpretations, the Elliott Wave Principle became quite popular during 1974 and early 1975. So contrarian that I am, I stopped using Elliott (at least in Dow Theory Letters) as soon as I realized that it had gathered a following.

Nevertheless, I do continue to study the market in Elliott terms. And because interest in Elliott has now simmered down, I want to review the whole market picture in terms of the Elliott Wave Principle again. I am really doing this for three reasons: (1) Because I believe it may be helpful to subscribers during this very difficult period, (2) Because I just received some very interesting new material from Frost, and (3) Because Dow Theory Letters is the only widely-circulated publication left which discusses Elliott on the basis of A. W. Frost's interpretations (if Ham Bolton were alive I am fairly sure he would agree with the interpretations included in this mailing).

To be very brief, the Elliott Wave Principle is based on the theory that all bull movements take the form of five waves (three up and two intervening corrective waves down). All bear markets take the form of three declining waves (two down and one intervening corrective leg up). I simply do not have space here to go into the rationale for these statements, but suffice it to say that



Elliott (there was an R.N. Elliott, and he wrote during the 1930's) based his views on a "law of nature." That law notes that the three and five series are seen over and over again in nature (this has been documented in many earlier issues of Dow Theory Letters).

At any rate, I include a re-drawing of a very long-term Dow chart which Frost has just sent to me. I concur in Frost's classification and interpretation of the waves and sub-waves. Of major importance is the super-wave concept which is illustrated on this chart. The super-wave premise states that a giant bull thrust began in 1932, and that bull movement is still very much in force.

Elliott made much use of "channeling" in his appraisals of current and future market movements. Channeling is the process of drawing parallel lines through high and low points of market movements, and it is a whole separate study in itself. However, it is an integral part of Elliott.

As you can see (page 4 chart), a rising trendline has been drawn connecting the 1937, the 1960 and 1966 tops. Incredibly, a parallel line can be drawn which connects the 1933, 1942 and 1974 bottoms. The fact that the parallel line starting from 1933 does contain the 1974 bottom suggests that the 1974 low was extremely important, more important, for instance, that any other low in modern memory.

All right, now let's go over the major wave patterns since 1932. The first ascending wave (Wave I on the chart) of the great primary bull upthrust was actually the 1932-37 bull market. Wave II was a bear market and developed as a perfect a-b-c pattern, carrying down to the 1942 low (amid the crisis of World War II). Major rising Wave III extended in the form of five sub-waves (number 1 through 5 on chart) to the final 1966 top. This was the point at which I called the termination of the great 1949-66 bull market.

Next came major corrective Wave IV, a wave which again assumed the form of a perfect A-B-C bear market. Wave IV carried the Dow down to the historic December, 1974 low (577. 60). From the 1974 bottom, major Wave V is now underway.

From an Elliott standpoint, the most important thing we can perceive at this point is that we are now in the final mighty up-wave of the super-bull market which began in 1932. Personally, I like to use Elliott in conjunction with Dow Theory, and of course Dow's Theory entails a good many other factors such as yields, values, sentiment, phases, etc. It is my opinion that we are in the earlier stages of a major bull market, a bull market that will (perhaps like the bull market of 1949-66) contain a good many smaller bull and bear swings). But I do think that the late-1974 lows represented a great buying area, and I do think that we will see very much higher prices for stocks before we ever see the 1974 levels again.

What does Frost think now? He believes that the bear market (or major Wave IV) ended in December, 1974, and the Wave V of the super-bull market began from the December, 1974 low. Frost is of the opinion that Wave V will be a very big bull market, carrying perhaps to 1500 or even 2000 on the Dow (see upper channel on the chart). He feels that Wave V could take 8 years or longer to unfold.

Now this is very important (turn to the smaller Elliott chart above). Frost notes that the first leg of a bull movement is usually shorter than the second leg. But note that the rise from December, 1974 (577 on the Dow) to the July, 1975 high (881) was 304 points. But the rise from the October, 1975 low (784 on the Dow) to the July, 1976 peak (1011) was only 227 points. Thus the second leg of this bull market is (so far) shorter than the first leg. When this happens, it is probable that the second leg is extending and what seems like the "shorter leg" is merely the first sub-wave of a five-leg uptrend. Thus, Frost believes that the second sub-wave of this bull market (B-C on the chart) is only now getting started!

For my part, I quite agree with Frost, and I believe that we are currently probing and stabing for a very important bottom from which to launch the next bull swing in this early part of Wave V. I feel that the frustration, consternation and skepticism being generated now all go a long way toward building a healthy base for the coming rise.

Question: What about the elections, how can you draw all these "conclusions" without even knowing whether Ford or Carter will win?

Answer: Elliott patterns swallow up news events the way an elephant would swallow acorns. Who in this world actually knows whether the market would take a Ford victory bullishly—or bearishly, or how it would take a Carter victory? "News goes with the trend," runs the old Wall Street adage. And the trend has an extraordinary way of going with Elliott (of course, our problem is interpreting Elliott correctly).

Question: Come on Russell, the pound sterling and the British market are collapsing, business here is sloppy, the stock market has been reeling, investors are worried and yield-minded, debt is piling to the sky in the US and the world, and you are presenting us with this Elliott "magic" nonsense. Do you expect us to swallow this stuff?

Answer: I offer people a look inside my head when I mail these reports. I happen to give Elliott a good deal of credence. In 1974 Elliott was a great help to me. It was also a great help to me in 1966. I follow Elliott, and since I do, I feel my readers would like to know one of the concepts that affects my thinking. I don't expect readers of these reports to "swallow" anything. You can only assimilate what you accept in your guts.

But I think Elliott is a serious study. Many highly intelligent men have followed the study. I don't expect miracles from Elliott. And my interpretations could be wrong at this time. In these Letters I try to convey to readers my own approach to the market, and of course many readers (who are far more knowledgeable than I) simply read these reports for perhaps a single new idea or merely to check their own thinking against mine.

NOTE: I regret that many subscribers do not have access to past Letters in which I have gone into detailed explanations of the Elliott Wave Principle (as applied to the market and to individual stocks). I have gone back through eight years of Letters, and arranged a number of (what I consider) important Elliott articles into a pamphlet. Anyone who would like this 18-page pamphlet may have one for $15 postpaid. Please send a check made out to Dow Theory Letters. If we receive less than 100 request, we will probably Xerox these pages. If we go over 100, we will run a special printing.

LATE NOTES: The Dow, for the first time since the bull market began (in late-1974), has dropped under its 200-day moving average. This denotes a greater degree of fear or pessimism on the part of large investors than we have seen in the past two years (since investors are now unwilling to pay as much for the 30 blue chip Dow stocks as they have been, on average, over the last 200 days.) Just as enthusiasm ran very high as the Dow pushed above the 1000 level, this correction is fated to terminate amid great pessimism.

The big volume "key reversal day" of September 22(described in the last Letter) proved to be the key all right. Odd lotters cut back on their selling as the market came down, a negative indication. The first day of increased odd lot selling occurred on October 12, and thus the beginning of "bottom psychology" may be about to appear. But it will take time.

When the market turns down into a secondary correction, there is a bearish potential buried somewhere in the market's unconscious, a downside level to which the market means to go. It's simply a matter of how the market is going to get there. No one knows what the bearish potential ahead is, it could be 910 on the Dow, 885, we just don't know.

The market itself decides how it is going to reach that bearish potential. For example, if the bearish potential ahead is Dow 900, then the Dow can get down there in one fell swoop, it can rally and decline violently, or it can dribble down in a three-month zig-zag pattern. It will pick it's own path to the bottom. What we try to do is gauge the figures and sentiment in an effort to identify the point (or area) at which we can say, "This looks like it, this looks like the area at which the market has expressed its full pessimism and where it has discounted the worst that it can see ahead."

Most secondaries take the form of two declines separated by a rally (although some large secondaries will become even more complex). This reaction has taken the Dow lower (since the September 21 peak) on 12 out of 14 trading days, all in the form of a single declining leg. That's downside compression, and it suggests that wherever this baby is going, it's not wasting any time getting there. Some of my trading indices are now at their most oversold since August, 1975, and one is at its lowest level since the 1974 bear market low.

I want to say something about investor psychology now. Already, a few of the advisory publications have stated that "a major top" has formed and that we are in a new primary bear market (one has stated that the old primary bear market has resumed). This morning's (radio) stock market forecast recited a list of adverse factors that made me want to go back to bed with a Librium in one hand and a Colt .45 in the other.

There's no doubt about it, things look bad, but when (I ask myself) did a correction in the second phase of a bull market ever look good? Right now, I'm watching two areas carefully, the bond-utility sector and the 13-week and 50-week moving averages of the Dow. As long as those areas remain on the bullish side of the ledger, things should be all right. If the bonds and utilities (both) start hitting the skids, I'm not going to like it. And if the 13-week MA crosses below the 50-week MA, I'll advise all my subscribers to pay the full cost of insurance and to get totally on the sidelines as far as any common stocks are concerned.

In the meantime, the downside compression continues, and the big stocks and holdouts are being jarred (today, it's IBM). General Motors has been the outstanding big holdout. When they hit GM, we'll probably be very near the bottom.

I want to caution subscribers regarding "jumping in" when the true bottom finally arrives for this correction. A correction bottom may take three or four months to complete. For instance, the Dow hit 419.79 (the bottom) in October, 1957. It bounced around, but by February, 1958 it hit a low of 436.89. Then the real rise began. Again, in June, 1962 the Dow smashed down to a low of 535.76. Again, the bouncing at the bottom, and by mid-October the Dow sank to 558.06. Thus, each bottom took four months to complete. That means that there is usually no hurry to catch the ultimate correction bottom if you are a buyer. It also means that following the first bounce off the bottom, there is usually a second decline that "tests" the bottom (and sometimes the second decline breaks the lows on very low volume).

STOCKS, GOLD, SILVER: According to Ray*Signals (43 Lake Ave., Montrose, PA 18801), an outfit that does a tremendous job with relative strength (RS) studies, the Crude Oil group has now turned up in RS after a three-year decline. This group includes Amerada Hess, Superior Oil, Atl. Richfield. Other RS "ups" this month are NY State Elec. & Gas and Boston Edison. Downward RS group this month is Metal Fabricating. Also down (unfortunately) are Bethlehem Steel, Int. Paper (both Dow stocks) plus Monsanto, Pillsbury, Celanese and BankAmerica ....Gold: what can I say, RS of the gold group has been down ever since September, 1974, and it's still down. We stay away until it turns up. Silver: leave it to Mr. Bunker Hunt. He may think silver can beat a gold bear market, but I don't.

Next Mailing: October 28th.